

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

June 3, 2014

Third Party Communication: None
Date of Communication: Not Applicable

Number: **201448020**
Release Date: 11/28/2014

Index (UIL) No.: 611.00-00, 611.02-04
CASE-MIS No.: TAM-149207-13

CC:LB&I:CTM:PNX

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Company A =
Company B =
Date 1 =
a% =
Mine A =
b% =
Date 2 =
Commodity =
Audit Period =
\$c =
d% =
\$e =
g =

\$h =
i =
i =

ISSUE:

Should the transfer of Taxpayer's b% interest in Mine A, when Taxpayer retained a bonus royalty and a production royalty, be treated for tax purposes as a lease or a sale of minerals?

CONCLUSION:

The transfer of Taxpayer's b% interest in Mine A, when Taxpayer retained a bonus royalty and a production royalty is treated for tax purposes as a lease of minerals.

FACTS:

Taxpayer, an international mining company, acquired Company A as part of a stock acquisition on Date 1. Prior to its acquisition by Taxpayer, Company A purchased an a% interest in Mine A. Company A subsequently, purchased additional interests in Mine A, and owned a b% interest during the Audit Period. The owners of Mine A treated this as a joint venture, and elected out of being treated as a partnership under Subchapter K. Therefore, each owner includes on its own return the operating income and expenses with respect to its ownership interest.

On Date 2, Company A transferred its b% interest in Mine A to Company B for \$c and retained two interests, a production royalty and a bonus royalty. The production royalty, which burdened the b% interest transferred by Taxpayer, is payable on a sliding scale topping out at d% for Commodity prices above \$e, beginning after g reserves have been produced. The bonus royalty, a single lump sum of \$h, is payable to Taxpayer within i days after cumulative reserves of j are added to the existing reserves.

LAW AND ANALYSIS:

Section 611(a) of the Internal Revenue Code (Code) provides, in part, that in the case of mines, oil and gas wells, other than natural deposits and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. The Code provides for two basic types of depletion allowance. Cost depletion is provided for in § 612 and percentage depletion in § 613.

Section 1.611-1(b) of the Income Tax Regulations provides that the annual depletion deductions are allowed only to the owner of an “economic interest.” Section 1.611-1(b)(1) further provides that the term “economic interest” is defined as follows:

An economic interest is possessed in every case in
Which the taxpayer has acquired by investment any
interest in mineral in place ... and secures, by any
form of legal relationship, income derived from the
extraction of the mineral ... to which he must look for
a return of this capital.

Section 1.614-1(a)(2) provides that the term “economic interest” includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under § 636, production payments.

Whether the conveyance of an interest in a mineral property is classified as a lease or as a sale or exchange depends upon whether the transferor retains an interest in the mineral property and the nature of the interest, if any, retained by the transferor. When the transferor assigns all of his or her interest in a mineral property or a fractional interest that is identical to the interest retained, or when a transferor assigns a continuing nonoperating interest and retains a working interest, the conveyance is classified as a sale. On the other hand, when the transferor assigns the operating rights and retains a continuing nonoperating interest the conveyance is classified as a lease or sublease. See, e.g., Burnet v. Harmel, 287 U.S. 103 (1932); Palmer v. Bender, 287 U.S. 551 (1933)

In Ridley v. Commissioner, 58 T.C. 439 (1972), the taxpayer received an upfront payment at closing and no further payments until about 42% of the ore body had been extracted. If thereafter extraction exceeded that threshold the taxpayer would receive a royalty for the balance of the deal. The Tax Court held that no sale had occurred, stating that the advance payment was a bonus or advance royalty even though the taxpayer argued that it had no remaining interest in the first 42% of minerals extracted from the premises because the taxpayer had already been paid.

In the instant case, Taxpayer transferred its b% interest in Mine A for an upfront cash payment, and retained a bonus royalty and a production royalty. The transfer constitutes a lease if Taxpayer retained an economic interest. The only relevant legal issue, then, is whether either the bonus royalty or the production royalty is in fact an economic interest in minerals in place. If either is an economic interest, then Taxpayer’s retention of the interest is inconsistent with sale treatment, and lease treatment must apply to the instant transaction. Sale treatment is applicable only where there is a complete and total alienation of the Taxpayer’s entire economic interest.

The bonus royalty is payable to Taxpayer within i days after cumulative reserves of j are added to the existing reserves, without regard to whether any minerals are produced and sold. Under § 1.611-1(b)(1) in order for an interest to qualify as an economic interest the owner of that interest must derive income from the extraction of mineral to which the owner looks for a return of capital. The bonus royalty is payable without regard to production. Therefore, Taxpayer's income from the bonus royalty is not derived from the extraction of mineral. Consequently, the bonus royalty does not qualify as a retained economic interest.

The remaining question is whether the production royalty qualifies as a retained economic interest. The production royalty is payable on a sliding scale topping out at d% for Commodity prices above \$e, beginning after g reserves have been produced. Because Taxpayer's income is derived from the extraction of minerals and can only be satisfied from the extraction of mineral, the production royalty qualifies as an economic interest for purposes of § 1.611-1(b)(1). The fact that Taxpayer's production royalty is preceded by a production holiday and is subject to a sliding scale regarding certain Commodity prices does not prevent the production royalty from being treated as a retained economic interest in minerals in place

CONCLUSION

Therefore, we conclude that Taxpayer has retained an economic interest in minerals in place through the retention of the production royalty regardless of the contingencies related to that production royalty.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.